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INSURANCE

Beyond Leverage: Split-Dollar Funding Of The GST-Exempt Trust

Abstract: GENERATION SKIPPING TRANSFER TAX (GST) exempt trusts are frequently funded with life insurance. By allocating the $1,000,000 lifetime GST exemption to the insurance premiums gifted to the trust, the exemption is "leveraged" so as to shelter the entire death benefit from GST taxation. In this manner a "Family Bank" can be created, benefitting several generations without transfer taxation. Funding such a trust through a traditional split-dollar insurance plan could create a benefit beyond leverage, by virtually eliminating the need to utilize GST exemption even for premium payments.

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Much has been written about the generation-skipping transfer tax exempt trust, an important family financial planning vehicle, which I like to refer to as the "family bank." The family bank is a trust established for the accumulation of substantial wealth, to benefit a given family through several generations — without diminution by the normal wealth transfer taxes (i.e., the gift tax, estate tax and generation-skipping transfer tax). It is referred to as a family bank because, like a bank, the trust is a prime resource for the funding of the particular needs of the various beneficiaries in successive generations.

A family bank can potentially be maintained for 80-100 years or more without diminution by transfer taxes. The key tax planning element in the creation of a Family Bank is avoidance of the generation-skipping transfer ("GST") tax, and this is accomplished through "leveraged" use of the founding grantor's $1,000,000 lifetime GST tax exemption. A popular means of leveraging the GST tax exemption is through life insurance. While it is beyond the scope of this article to explain the operation of the GST tax and the $1 million lifetime exemption in detail, the key point here is that the proceeds of a life insurance policy of several million dollars can be completely sheltered from GST tax by allocation of the transferor's available GST exemption merely to the premiums paid for the policy. Thus, for example, in a case where a trust acquires a $5 million life insurance policy, and the grantor pays annual premiums (through gifts to the trust) aggregating $1,000,000, by allocation of the grantor's $1 million GST exemption to the premium payments, the entire $5 million of eventual policy proceeds, and future growth of this fund, can be completely sheltered from future GST taxation, as the fruits are enjoyed by succeeding generations of family members.

While the often-utilized irrevocable life insurance trust offers significant opportunity for leveraging of the GST exemption, the $1 million lifetime exemption must be utilized at least to the extent of the cumulative dollar amount of premiums paid over the life of the insurance policy. Although this provides very significant leverage, there may be a way, in certain situations involving corporate executives, to fund a family bank with life insurance proceeds, without even having to allocate GST exemption to the annual premium payments, and thereby preserve the GST exemption for other transfers. This involves the use of a split-dollar life insurance plan. While split-dollar appears to allow leveraging of the GST exemption to a degree that the IRS would likely consider offensive, there is a strong technical argument in support of this technique, within the framework of existing IRS rulings.

Under a typical split-dollar life insurance arrangement the insured party is a corporate employee and the employer pays the insurance premiums. The plan is structured so that the employer and the employee's beneficiaries share in the policy death benefit upon the employee's death. The ownership of the policy and the split of the proceeds will depend upon the type of split-dollar arrangement which has been agreed to.[1] In order to establish a family bank with a split-dollar policy, the employee-insured would create a trust to which he would assign all of his rights under the split-dollar agreement. Thus, the trust would eventually receive the employee's share of the death benefit. What then are the tax consequences of the employer's annual payment of premiums, and must the employee-insured allocate GST exemption to the premium payments in order to shelter the trust from future GST tax,

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as would be the case with the typical GST exempt life insurance trust?

A strong technical argument can be made that, in the case of term insurance and in the limited context of split-dollar plans, a life insurance trust can remain exempt from GST tax without the need to allocate GST exemption to premium payments each year. The legal argument is based primarily upon a series of IRS rulings on the gift tax consequences of the payment of life insurance premiums by employers, where the policies are owned by trusts or other third parties.

These rulings generally state that the payment of the premiums by the employer, to the extent of the value of the "current" insurance protection, are deemed income to the employee and gifts from the employee to the trust or other third-party policy owner. Under IRS rulings, the value of the "current" insurance protection is measured by either the government published P.S. 58 rate or the insurer's generally available individual one-year term rate.[2]

In Rev. Rul. 78-420, 1978-2 CB 67, a policy on the life of a key employee was owned by the employee's wife under a split-dollar arrangement with the employer corporation. Relying upon the basic split-dollar rule established in Rev. Rul. 64-328, 1964-2 CB 11, this ruling held that the employee must include in income the value of the insurance protection in excess of the premiums paid by his wife. The ruling goes on to hold that the value of the life insurance protection provided by the corporation which is included in the income of the taxpayer is "deemed to be transferred by the taxpayer to his wife for purposes of Sec. 2511," and subject to gift tax.

A virtually identical fact pattern was presented in Letter Rul. 8003094, where the wife of a corporate employee owned a policy on the employee's life, under a split-dollar arrangement under which the employer paid the full premiums. Citing Rev. Rul. 78-420, the same result was reached attributing income to the employee equal to the value of the insurance protection, and further holding that such amount is also deemed to be transferred by him to his wife as a gift.

In Rev. Rul. 81-198, 1981-2 CB 188, the insurance policy was owned by a trust for the benefit of the employee's child, under a split-dollar arrangement providing a sharing of the premium payments between the employee and the corporation. The ruling holds as follows (the employee being identified as "D"): "D's annual premium payment is a transfer by D for purposes of Sec. 2511 of the Code. See Sec. 25.2511-1(h)(3) of the Regulations. Further, the value of the life insurance protection provided by the corporation, which is included in the income of D, is deemed to be transferred by D for purposes of Sec. 2511 of the Code." Rev. Rul. 78-420, supra, is cited.

The same general principles are applied in Rev. Rul. 76-490, 1976-2 CB 300. Although not a split-dollar situation, this ruling is relevant because it involves a group term insurance policy on the life of an employee who assigned his rights to a trust. The ruling holds that "each premium payment made by the employer . . . is deemed an indirect transfer by [the employee-insured] to the assignee of the policy for purposes of Sec. 2511 of the Code, and subject to the gift tax imposed by Sec. 2501."

The significance of the quoted statements in these income and gift tax rulings is the repeated pronouncement that there has been a gift in the amount of the value of the life insurance protection (to the extent that such value was indirectly provided by the employee-insured). Applying this IRS dictum in the context of the GST tax, we start with the proposition that the only gifts which are ever made to the GST trust (in cases where the trust was the original owner of a split-dollar policy) are annual gifts of the value of the insurance protection (i.e., the lower of the PS 58 or the insurer's term rates).

We must now turn to an analysis of the mechanics of the computation of the GST inclusion ratio applicable to the life insurance trust. The inclusion ratio is keyed to the computation of the so-called "applicable fraction." Under IRC Sec. 2642(a)(2) the numerator of the applicable fraction is the amount of GST exemption allocated to a transfer into the trust, and the denominator is the value of the property transferred, as of the date of the transfer [subject to certain adjustments not applicable here].

Let's assume that in the first year of the policy the value of the insurance protection paid for by the employer (and deemed gifted by the employee to the trust) is $20,000. Assuming that no GST exemption is allocated, the applicable fraction immediately after the premium payment would be zero (0/$20,000), and the inclusion ratio would be 1. If the insured were to die within the first year without having allocated GST exemption to the $20,000 gift to the trust, the GST exemption could still be allocated after his death by his executor (assuming that the entire $1,000,000 GST exemption had not been previously allocated).

Upon the death of the insured during the first year, the trust would receive the death benefit and would reimburse the employer for its share. If we stop here and analyze the situation as only a 1-year scenario, it is hard to see how the IRS would have a handle to compute the applicable fraction and the inclusion ratio in any other way. In this connection, an even purer theoretical case would be presented if the insurance was not split-dollar, but term insurance, as in Rev. Rul. 76-490, supra.

Does the technical analysis change once the plan has been in effect for several years? I submit that it does not, as long as the following remains true: a) the trust at no time has any assets other than the split-dollar policy; and b) the split-dollar plan is structured so that the employer is entitled to receive no less than the full cash value as of the date of death.

Let's go on now to the second year of the policy. At the end of the first 12-month period, the value of the employer-provided theoretical term insurance coverage will have expired; at that point, unless the insurance protection element of the policy for the second year is paid for the insurance protection will

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lapse, and the insurance policy will no longer have any value to the trust. In other words, when an insured is deemed to have made a gift of the value of the insurance coverage to his irrevocable trust, in the case of a typical split-dollar plan falling under Rev. Rul. 64-328, or in the case of term insurance, he has made a gift of an asset which declines in value, and at the end of the policy year, has no value. Thus, in effect, if the transferor-insured survives to the end of the policy year there is no longer any property in the trust to which GST exemption need be allocated. This is an important point in connection with the computation of the applicable fraction when there is a gift to a trust to which gifts have been made in previous years.

The mechanics are spelled out in IRC Sec. 2642(d), which essentially cumulates the current gift with the current value of past gifts in computing a new cumulative fraction. However, it is critical to note that the denominator of the fraction is the value of the current gift, plus "the value of all the property in the trust (immediately before such transfer)." IRC Sec. 2642(d)(2)(B)(ii). If the payment for the second year's insurance protection is deemed to be made (and gifted to the trust) immediately after the expiration of the first policy year the denominator to be used in the applicable fraction at the time of this deemed gift would be only the value of such deemed gift (i.e., the insurance protection for the next 12 months); there would be no other assets in the trust to add under the above-quoted clause of Sec. 2642(d). Thus, in the second year, and in each succeeding year, the amount of GST exemption which would have to be allocated (as the numerator) to achieve a 1/1 applicable fraction, would be no more than the deemed-gift of insurance protection value for that year (the value of all prior year's gifts having expired), and that allocation need not be made unless the insured dies during the policy year, and then may be made after his death by the executor. (See the discussion below concerning a potential technical problem if the insured should die after October 15 of the calendar year.)

At its root, the foregoing analysis starts with the basic theoretical analysis of split-dollar first enunciated by the IRS in Rev. Rul. 64-328 and expanded upon in the subsequent rulings discussed above: that the employee receives income (and makes a gift) in the amount of the value of the insurance protection only. I see no viable basis by which the IRS, under the present state of the law, could prevent the expansion of this concept into the mechanics of the computation of the inclusion ratio and applicable fraction for GST purposes.

Might the IRS take the position that the policy cannot be divided for GST purposes between the trust's portion and the company's portion? While the IRS could eventually rule that none of the prior rulings have applicability for purposes of the GST tax exemption computations, I fail to see any rational basis for making the distinction, without modifying the fundamental theory of split-dollar income taxation laid down in Rev. Rul. 64-328.

While the utilization of the extraordinary potential leveraging of the GST exemption through split-dollar in the manner discussed above has not been tested and does present risks, if for no other reason than the extreme magnitude of the potential GST tax shelter, the risks can be reduced and the technical argument can be presented in its cleanest form only if the trust at no time possesses any assets other than its interest in the pure insurance protection. If the policy has any other element of value which does not ultimately belong to the company under the split-dollar agreement, that value may find its way into the denominator of the applicable fraction and produce a positive inclusion ratio, albeit perhaps a small one (unless GST exemption can be allocated to such value component in time). (Might the IRS argue, for example, that in addition to the value of the current year's insurance protection, the policy owned by the trust has certain intangible elements subject to monetary valuation, such as the annual renewal right? In the case of a policy having a cash value, even if the corporation is ultimately entitled to the entire cash value, the IRS could conceivably attribute an intangible value to the current availability of the surrender value to fund future years' insurance protection. This argument would probably fail, however, if, under the plan, the corporation could at any time eliminate the cash value by withdrawal or surrender and termination of the plan.) While this overall risk might be dealt with through the use of the "endorsement" method of plan documentation, where the corporation is the policy owner and would be entitled to any such tangible or intangible elements of value, as a practical matter, this method cannot be used in cases where the insured is a controlling stockholder of the corporation. The corporation would hold "incidents of ownership" in the policy which would be attributed to the insured, resulting in the trust's portion of the death benefit being included in the insured's gross estate. Estate Tax Regs. Sec. 20.2042-1(c)(6).

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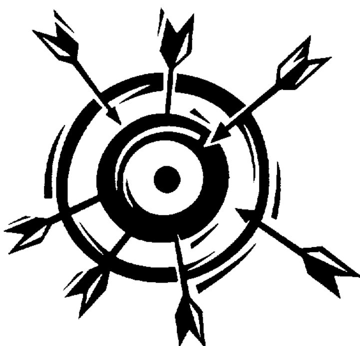

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the difference between the "traditional" form of split-dollar, in which the corporation is entitled to the entire cash value upon death (regardless of whether this amount is greater than the premiums actually paid by the corporation), and "equity" split-dollar, in which the corporation's interest is limited to reimbursement of actual cash contributions, and any cash value in excess of cumulative reimbursable contributions accrues to the employee (or his assignee, in this case the irrevocable trust). In the case of the equity type plan, as soon as the cash value begins to exceed the cumulative reimbursable premiums, the policy will have a value in the hands of the trust which will have to be included in the denominator of the applicable fraction.

Thus, if a split-dollar plan is to be established with a prime objective of taking advantage of the potential GST exemption leverage, an equity-type plan would best be avoided, and policy ownership by the corporation would be preferable to ownership by the trust, but only if the insured is not a controlling stockholder of the corporation. If the insured is a controlling shareholder, the primary consideration has to be assuring, for estate tax purposes, that the corporation possesses no "incidents of ownership." This means that the GST trust must be the owner of the policy and possess all incidents of ownership. To the extent such incidents of ownership have measurable value as of the date of the gift of the insurance protection value for the year of the insured's death, the value of these incidents of ownership would require additional allocation of GST exemption by the executor after the insured's death in order to maintain a zero GST inclusion ratio.

Effect Of GST Exemption Allocation Filing Deadlines. A close look at the mechanics for the GST exemption allocation reveals a potential technical obstacle when the subject split-dollar insurance has a policy anniversary date which falls between October 15 and December 31. Assume, for example, a case in which premiums are paid each year on or around November 15. The GST leveraging plan outlined above, in its purest form, would not involve allocation of any GST exemption until after the death of the insured (when it would be necessary to allocate exemption only to the value of the term protection purchased with the prior November's premium payment). However, such a post-death allocation will not produce a zero inclusion ratio for the trust if the allocation is not made within the requisite time period for the filing of a Form 709 for the calendar year in which the last premium payment was made, as explained below.

Ordinarily, the allocation of GST exemption is made in a timely filed gift tax return (Form 709) for the calendar year in which the GST was made.[3] The due date for filing the Form 709 is April 15 of the year following the calendar year of the transfer; but this date may be extended to October 15 of such following year.[4] An allocation made in such a timely-filed Form 709 is referred to as a "timely allocation." Despite this apparent deadline for making the GST exemption allocation, an allocation can actually be made at any subsequent point during the lifetime of the transferor and even subsequent to his death (up to the due date for filing an estate tax return).[5] However, there may be a significant difference in the amount of exemption which must be allocated to a given transfer if the allocation is made subsequent to the applicable Form 709 due date (referred to as a "late allocation"). In the case of a timely allocation, the value of the property transferred is determined as of the date of the transfer. In the case of a late allocation, the value is determined, and the transfer is deemed effective, as of the date that the Form 709 is filed or by election (other than with respect to a life insurance policy or a trust holding a life insurance policy, if the individual has died) valued on the first day of the month during

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which the late allocation is made.[6] Thus, if there is a late allocation, the amount of available GST exemption which would have to be allocated in order to cover the entire amount of the transfer might be more or less than the value of the property at the time of the transfer, depending upon whether it has increased or decreased in value between the time of the transfer and the date of filing the Form 709. In addition, the denominator of the "applicable fraction" used in the computation of the inclusion ratio would include any other assets which may have been acquired by the trust between these two dates. (In this connection, if the insured has died, the trust will include the entire amount of the insurance policy proceeds.)

Thus, in the current example, if the insured were to die at any point prior to the final date for filing of a timely allocation with respect the most recent November premium payment [i.e., by April 15 (or October 15, if an extension has been granted) of the following year], the decedent's personal representative could make a timely allocation of exemption to the value of the term coverage purchased as of the date of the previous November premium payment. Assuming that the trust had no other assets at that time, this would retroactively create a zero inclusion ratio for the trust, so that the entire death benefit received by the trust would be GST tax exempt.

On the other hand, if the insured were to die on October 31, it would be too late to make a timely allocation with respect to the previous November premium payment. If a late allocation is made it will do little good, since the inclusion ratio will have to be computed as of the date of the filing of the late allocation, at which time the entire amount of the policy proceeds will have been received by the trust and be includable in the denominator of the applicable fraction.

It would appear that the easiest way to avoid this problem is to be sure that the policy premium anniversary date falls between January 1 and October 15, preferably before April 15.[7] In the case of a policy anniversary date falling subsequent to the final date for a timely allocation, the problem might be dealt with through allocation of relatively small amounts of GST exemption each year. Thus, no allocation is made until after the filing deadline for a timely allocation, and on the first day subsequent to such deadline, a late allocation is filed. Since the allocation is a late allocation, the amount to be allocated is based upon the remaining value of the term protection as of the date of the allocation. For example, if the last premium anniversary date was November 1, and the allocation is made as of October 16 of the following year, only a small fraction (16/365) of the value of the term coverage remains as of the date of the allocation.[8]

While the use of split-dollar insurance to leverage the GST exemption appears to offer potential GST tax shelter to a degree surpassing even that of the typical insurance-funded "dynasty trust" (where GST exemption ordinarily must be allocated at least to the full amount of premiums paid each year), this is not something for the faint of heart. It is highly aggressive, as yet untested, and involves potential technical traps which require extremely careful planning, continuous monitoring, and follow-up by the estate's personal representative with respect to the critical post-death GST exemption allocation. ◆

End Notes

1. It should be noted that the form of split-dollar plan contemplated in this article is the so-called traditional split-dollar plan in which the employer is entitled to the full cash value of the policy. The recent IRS pronouncement in TAM 9604001, which adversely affects "equity split-dollar" plans, does not affect traditional plan designs wherein the corporation's security interest is equal to the policy cash value.
2. Rev. Rul. 64-328, 1964-2 CB 11; Rev. Rul. 66-110, 1961-1 CB 12.
3. Reg. 26.2632-1(B)(2).
4. IRC Sec. 6075(b).
5. IRC Sec. 2632(a).
6. Reg. 26.2642-2(a)(2).
7. Any premium anniversary date subsequent to April 15 would require filing every year for extensions of time to file the Form 709, in order to protect against the possibility of death subsequent to April 15.
8. Use of a formula allocation may be appropriate.

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